OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

December 2012

IMF nods approval of capital controls

At last, this may be beginning of wisdom at the Fund

Meghnad Desai, Chairman, Advisory Board

At last, the International Monetary Fund has changed its stance on capital controls, setting out its 'institutional view' which shifts position in a way the emerging economies have been urging for decades.

Capital controls are now to be called Capital Flow Management Measures (CFMs). 'Controls' smack of dirigiste regimes, while 'management' is entirely kosher. Either way the IMF has now nodded realistically in the right direction.

Even though the espousal of capital controls is guarded, let's hope this thin end of the wedge represents the beginning of wisdom at the IMF.

The executive summary of the Fund's paper, 'The Liberalisation and Management of Capital Flows', says: 'In certain circumstances, capital flow management measures (CFMs), i.e. measures that are designed to limit capital flows, can be useful and appropriate. These circumstances include situations in which the room for macroeconomic policy adjustment is limited, or appropriate policies take undue time to be effective.' Furthermore, CFMs have to be 'targeted, transparent and temporary'.

There are cogent reasons why the IMF had to rethink its viewpoint. In its heyday, it espoused a strong version of monetarism and New Classical economics, Chicago-style. Now, with the Fed and the Bank of England issuing money like there is no tomorrow, calling it QE, the tenets of monetarism have been thrown to the winds.

The emerging economies are suffering the consequences of the west's monetary emissions. Hot money has no way to find high returns at home and so is invading emerging market economies.

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Turkish central bank capital inflow measures seen as model for others

Market-orientated measures introduced by Turkey to damp capital inflows are finding increasing favour among emerging market economy central banks. Unconventional policy tools to prevent an undue appreciation of the Turkish lira outlined in Jakarta in November by Turkish Central Bank board member Ahmet Faruk Aysan provoked interest from Bank Indonesia as a possible model for other countries. The Turkish measures include different options for reserve requirements that act as automatic stabilisers for foreign exchange markets. *(continued on page 8 ...)*

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Iwata ahead

Japan succession

Shumpei Takemori, Advisory Board

Kazumasa Iwata, president of the Japan Center for Economic Research, seems to be inching ahead as the favourite to take over next April as Bank of Japan (BoJ) governor from incumbent Masaaki Shirakawa, according to well-informed opinion in Tokyo.

The Japanese election on 16 December, which resulted in a decisive victory for Shinzo Abe's Liberal Democratic Party (LDP), and the active politicisation of the BoJ, will make this issue a closely watched contest as politicians struggle to end Japan's long-standing deflation.

Abe has won a clear majority in the lower house of parliament, leaving his hands relatively free. But in choosing the new governor to push through his anti-deflation policy, the LDP will need support from the Democratic Party (DP), making up the current government, which holds a strong position in the upper house.

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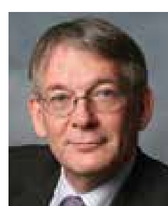

OMFIF three years on

Transition and transformation

David Marsh, Chairman

At the end of 2012, OMFIF will have been in existence for three years – a period of transition and transformation for the world economy, mixed with occasional turmoil. It has coincided with a slow deterioration of the crisis in economic and monetary union (EMU) and a gradual increase in the monetary power and influence of emerging market economies.

Very likely, we will see a continuation of both trends in 2013. Next year is unlikely to be significantly better for the euro area, and may be a lot worse. In other parts of the world (including the US), the outlook, though undoubtedly occluded, is distinctly brighter. Our end-year edition, encapsulating viewpoints from around the world, does ample justice to all these developments. It also records some of the meetings OMFIF held in November: in Mauritius, Jakarta and Washington as well as several European cities.

Darrell Delamaide, in his monthly round-up on the Fed, explains the background to the landmark announcement on 12 December that the US central bank is moving to an explicit unemployment target as a condition for keeping interest rates close to zero.

Meghnad Desai praises the International Monetary Fund decision to allow capital controls by countries (often from the emerging markets) seeking to protect their economies from unbridled free markets. Although in principle welcome, this does open a possible route towards more state control of capital markets. This is a theme taken up, too, by Michael Kaimakliotis in his review of 12 big events that are likely to influence the next decade – which include, he says, a shift to the left in international politics.

We look, too, at world payment imbalances and the IMF decision to extend its statistics for composition of foreign currency reserves. Lamido Sanusi, governor of the Central Bank of Nigeria, outlines Africa's challenges of fighting corruption and protectionism. This is an extract from a keynote speech at OMFIF's second Main Africa Meeting, with the Bank of Mauritius on 5-7 November, where we present a summary of proceedings.

One of OMFIF's main ambitions is to act as a conduit for exchange of best practice. On the front page, we record how the Central Bank of Turkey is using innovative market-based methods to curb capital inflows, using methods capable of being adapted by other emerging market economies – a subject aired at the Second OMFIF Asian Central Banks' Watchers Conference on 13 November in Jakarta. Shumpei Takemori outlines latest thinking in the leadership stakes at the Bank of Japan after the 16 December elections, where Kazumasa Iwata seems to be inching ahead.

Stefan Bielmeier examines the US fiscal cliff, a much-discussed subject at our seminar with the Atlantic Council in Washington on 16 November, and says falling off the monetary cliff would be even worse. Gabriel Stein explains why we should not lose sight of developments in credit growth. Steve Hanke describes how Basel III is choking off lending in the US and elsewhere. Allan Lane explores whether ETFs are better value for money than index funds. Darrell Delamaide looks at differences between long- and short-term asset management behaviour. Mojmir Hampl, deputy governor of the Czech National Bank, gives an acerbic view of European money: both Germany, and others who tried to dislodge it from its monetary throne, are displeased with the outcome. Anthony Robinson looks at Greek fears of another 1922-style Katastrofi. William Keegan takes a bitter-sweet look at Mark Carney's appointment as Bank of England governor. And he points to some parallels with Britain's 1960s and 1970s sterling balances experiences – episodes to which no new central banking chief would wish to return.

David Marsh

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Tackling corruption and protectionism

Time for Africans to take responsibility

Sanusi Lamido Sanusi, Governor, Central Bank of Nigeria

Africa has 15% of the world's population yet only 2.7% of world GDP. Although it is good news that African growth is forecast at 5.4% in 2013, this lags behind Asia, and is not much more than the countries affected by the Arab Spring. So we need to ask: What are the problems facing Africa? What are the real issues impeding our growth?

For example, we need to look at corruption: the problems that exist because of a small elite minority that profits from trade distortions. Nigeria represents the greatest potential in Africa. It could be the next China. But it represents, too, all the negative issues. It's the world's seventh largest oil producer, yet it imports oil products; people are profiting from these distortions. Nigeria is also the biggest producer of cassava, yet it has to import ethanol and starch. It's the world's largest importer of tomato paste – from China. It imports rice from Thailand and India. In general, if you rely on commodity prices, there's a problem. Any growth that benefits purely from higher commodity prices is vulnerable growth.

For Africa's growth policies, we talk about copying China and India, but in reality we're not doing that. Instead we're copying what Europe did in the past. The British did not follow David Ricardo's free market policies. Instead, Britain followed protectionism, policed by naval gunboats. Ricardian policies were like British exports – not for domestic consumption. So what can we do about the low productivity of African economies? African labour costs are now cheaper than China's. China has lost its cost advantage for labour. The difference is that China is a lot more productive.

Another problem is finance. Companies need to be able to borrow without going to the banks. Banks do not have time for small and medium-sized enterprises. If you can create one loan for $1bn then it doesn't make sense to do 500 or 600 smaller loans. So as regulators we have to encourage banks to lend to SMEs. The structure of the financial system is a major issue. Africa needs to leverage its own domestic savings.

We have to pay attention to governance issues. Investors need assurance that an investment over 20 to 25 years will not be undone because the government changes over that time. Any project that relies on cronyism and patronage will not attract investment. You cannot maintain contracts over a long period if this is all based on rent-seeking. Reform by definition requires an attack on certain established interests.

We have to challenge the entire system and the issue of rentier states. This is a matter for Africans ourselves. We cannot wait until someone else comes and tells us what to do, from Washington or somewhere else. We must take responsibility ourselves. If we did this, Africa would grow at 12% not 6%. We have low productivity. We produce oil, we produce gas – but we burn it all up. State, regional or local governments are able to make more money putting up bottlenecks than creating jobs.

I dream of an Africa where there'll be an oil pipeline from the Niger Delta to West Africa, from Nigeria to North Africa, from Mozambique and Angola to South Africa. Where there'll be hydroelectric power from the Nile and the Niger Delta across several countries. Where there'll be railroads across the continent. Why should it cost more to send goods from Yaoundé to Cape Town than from Shanghai to Cape Town? Africa is one big market. The binding constraint is access to these markets. Africa's problems are all about electricity and infrastructure, corruption and governance, financial sector development and reform, skills and capacity. That makes the difference between 3% growth and 12% growth. We all agree Africa is the next frontier. But Africans have to look each other in the eye and say we can do it. It is up to Africans to get on with it.

This is an edited extract of Governor Sanusi's speech to the Bank of Mauritius–OMFIF Gala Dinner in Port Louis on 5 November.

We have to challenge the entire system and the issue of rentier states. This is a matter for Africans ourselves. We cannot wait until someone else tells us what to do.

Price war adds weight to old questions

Versatility holds the key

Allan Lane, Managing Partner, Twenty20 Investments

A long-awaited price war among Exchange Traded Fund (ETF) providers has broken out, adding new ammunition to the old argument of whether ETFs are more expensive than index funds. With ETFs now accounting for $1.65tn of assets on a global basis, the top providers are understandably defending their market share.

Vanguard's plan to lower costs stunned the industry at the beginning of October. It announced that it would be dropping MSCI as the benchmark index for 22 of its ETFs and replacing them with six indices from the FTSE Group. It added that the other 16 benchmarks would be provided by CRSP, The Centre for Research in Security Prices at the University of Chicago.

A few days later, iShares announced its own plan on how it intended to regain market share lost to Vanguard. While reducing fees on some existing products, the company deftly ushered in a new core family of 'budget' ETFs. For the landmark Emerging Markets ETF, with ticker EEM and a 67bps annual management fee, iShares now offers a core version of its Emerging Markets ETF, ticker IEMG, complete with a rock bottom fee of 18bps. Since Vanguard said it would no longer use MSCI as its benchmark, it has seen $1bn in outflows from its Emerging Markets ETF. By contrast, iShares has enjoyed $2.8bn of inflows.

To analyse whether ETFs are more expensive than index funds, one should consider the total cost of ownership.

To analyse whether ETFs are more expensive than index funds, one should consider the total cost of ownership. How well does the fund track its benchmark index? Are there any upfront fees to the product? Is it trading at a premium or discount? Does the provider generate additional revenues by engaging in securities lending?

What looks like the best deal can look entirely different under further inspection. For example, a tracker fund benchmarked against the FTSE 100 Index may have a lower Total Expense Ratio (TER), but as a result of stamp duty it requires the investor to pay an upfront fee of 50bps. With an ETF, this stamp duty is inherently priced in and the ETF may trade above or below its theoretical Net Asset Value. Since the start of 2008, this premium/discount for the iShares FTSE 100 ETF has ranged from -7bps to 60bps, averaging 24bps, which is 26bps below the 50bps upfront fee levied on an index fund.

In the bond markets, much has been said about the continued growth of the High Yield Bond ETF segment with State Street's and iShares' US High Yield ETFs accounting for $25bn in assets under management. The ETF market often trades at much tighter spreads than that of the underlying index. In the case of iShares' US High Yield Bond ETF (HYG), over the last year the ETF at times traded with spreads as low as a few basis points, well below that implied by the index. This is exactly how it should be, as an ETF is mostly more liquid than its underlying securities. Of course, there is concern that only the professionals will manage to avoid getting hurt when the market sells off. Again, the headline management fee may not tell the whole story.

Are futures a cheaper way of gaining a given market exposure rather than using an ETF? An article in The Journal of Indexing earlier this year suggested that, for an investor wanting exposure to the S&P 500, rolling equity futures with an accompanying money market position on a quarterly basis over 10 years offered lower returns (on average of 80bps per year) compared with a buy-and-hold strategy using an ETF. This may not be true in general.

It's clear that the number of market exposures using futures cannot compare with the wide range of index benchmarks offered via an ETF. There are almost no 'bond-centric' benchmark indices available in the futures market, but plenty of exposures in the ETF market. The true value of ETFs lies less in the overall cost difference, more in their versatility and wide range of available exposures.

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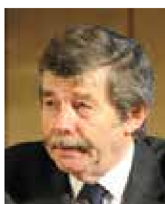

Learning the hard way

Carney faces shock when he gets to Bank

William Keegan, Chairman, Board of Contributing Editors

Seldom, if ever, has the appointment of a new Bank of England chief attracted so much publicity for so long and on such an international plane. Clearly, when announcing the appointment of Mark Carney, Governor of the Bank of Canada, UK Chancellor of the Exchequer George Osborne thought he had achieved a great coup – fooling the media and the City, and the punters who had made Deputy Governor Paul Tucker the odds-on favourite, while also achieving a symbolic victory over the Bank of England itself.

There is nothing new about Chancellors wanting to achieve the upper hand over the Bank, nor in wanting to go all the way to Canada.

As a racing man I am wary of backing odds-on favourites. Personally I feel sorry for Paul Tucker, who would in my opinion have made an excellent Governor with a little help from administratively-efficient colleagues, and who had thought a lot about what needed to be done to shake up the Bank – something an imported Governor from Canada may have to learn the hard way.

There is, by the way, nothing new about Chancellors wanting to achieve the upper hand over the Bank, nor, in wanting to go all the way to Canada. There was so much dissatisfaction with Montagu Norman towards the end of his long reign that the then Chancellor Kingsley Wood approached Graham Towers, Governor of the Bank of Canada, in 1943 in the hope that he could succeed Norman in 1944. This approach was less successful than Osborne's towards Governor Carney.

In fact, 'hot pursuit' would be the better expression. For the British Chancellor appeared to become star-struck in the presence of Governor Carney, courting him many times over the year and finally pinning him down at a Mexico meeting of the G20 early in November.

The Financial Times report early in the year on Osborne's designs on Carney clearly had substance to it. So, too, in the labyrinthine world of central banking and politics, did the denials. The spokesman's statement – 'The denials were right at the time' – sounded crazy but it was true. Osborne had indeed sounded out Carney but he, several times, emulated his predecessor Towers by rejecting a British approach.

Thanks to statements from Mrs Carney to the Canadian media, we now know that the Carney camp were not misleading us earlier in the year when explaining that Carney wanted to go into Canadian politics, and that was one of the reasons why he had spurned Osborne. But the gap Carney saw for his entry disappeared. He has now postponed the political stage of his lightning career until later in the decade. A five-year stint at the Bank of England became a convenient staging post.

Osborne was keen to get him. Carney had not even applied for the job – one of Osborne's original stipulations – and managed to negotiate himself a salary 57% above the £305,000 paid to Sir Mervyn King, plus all manner of additional benefits, at a time when Britain languishes under Osborne's misconceived austerity programme.

Whereas the British media and establishment went over the top in lauding the appointment, the Canadian press had more reservations. Andrew Coyne, Montreal Gazette, wrote: 'That our banking system was not so badly mauled by the crisis as others had less to do with Carney or any current office-holder than with the historical and policy inheritance they came into.' And Terence Corcoran, Financial Post, wrote that it was too early to judge the success of Carney's policies in Canada. 'He is leaving as a policy hero with the punchbowl still full and the party yet to get under way . . . Canada is a country club by British banking standards.'

Carney is widely admired for his chairmanship of the Financial Stability Board. One wishes him well. But the Bank of England is one hell of a test for him, and he is in for a shock when he discovers the state of the economy for which he is heading.

12 to remember from 2012

Big Events that will shape the world

Michael Kaimakliotis, Quantum Global Investment Management

The old year is ending with some basic concerns unchanged from 12 months ago: whether austerity in Europe will be self-defeating (yes), whether the US can stay ahead of China in the world power stakes (probably), whether Silvio Berlusconi will make a comeback (no). I have recorded here, from my own subjective (possibly idiosyncratic) perspective, 12 Big Events from across the fields of business, money and geopolitics that are likely to shape 2013 and beyond. A decade from now, we will look back and say these developments were significant factors for our future. We are likely to see even more activist monetary policies and a slower decline of fiscal deficits. Emerging economies, not just industrialised nations, will think twice about austere financial policies. The stage is set for higher world-wide inflation risks over the coming decade.

1. Obama's re-election shifts US politics to the left

President Barack Obama was re-elected in the US despite an unemployment rate of 7.9%. Mitt Romney's bland campaign was a factor, but demographic change played the decisive role. Obama carried 93% of black voters, 71% of Latinos and 73% of Asians. These demographic groups are growing rapidly. White voters made up 80% of the electorate in 2000 but only 72% in 2012. The share is likely to fall to 70% in 2016. In addition, 60% of those aged 18-29 voted for Obama. Unless the Republicans move to the left, they will have difficulty regaining the presidency and their success in Congress looks likely to fade. The outlook is for politics in the US to shift decisively to the left over the medium term.

2. Geopolitical map redrawn in North Africa and Middle East

The rise of the Muslim Brotherhood in Egypt has the power to transform the region – for better or for worse. President Mohamed Morsi has brokered a ceasefire between Hamas and Israel and then abruptly assumed extended powers with a decree putting himself above the rule of law (on a temporary basis of course). This shows the potential for both positive and negative outcomes. The Brotherhood has chapters throughout the Middle East. Their rise could threaten pro-western regimes such as Jordan. However, with power come responsibility and accountability. These bring the potential for a moderation of views and a reduction in the willingness to resort to violence.

3. China becomes more assertive

It's difficult to say whether China's more assertive stance is merely temporary posturing in advance of the once-in-a-decade change in leadership of the Communist Party and the move up the ladder of Xi Jinping, the new general secretary. In the same way, his no-nonsense approach to party bureaucracy may be nothing more than window-dressing. The diplomatic sabre-rattling over territorial claims is, at the very least, an opportunistic shift induced by perceived US weakness and the desire to establish a stronger stance in the South China Sea which is important for shipping routes and resources. Whether it's more than that may become clearer in 2013.

4. Myanmar emerges as a fulcrum for Big Power rivalries

Indian Prime Minister Manmohan Singh's visit to Naypyidaw, the capital of Myanmar, was one of many high-profile 2012 visits. Barack Obama was in town shortly after securing re-election on his way to meetings with the regional powers. The tussle for Myanmar will be between India, China and the US. It has much to offer as the pivotal point connecting the Indian subcontinent with south-east Asia and China. Its bountiful natural resources are the icing on the cake. The opening of Myanmar will create investment opportunities for much of the region as new trade routes emerge and north-east India improves its connections to China and the sea. China will do everything it can to develop an alternative to the Strait of Malacca through which 80% of China's oil imports pass (and 40% of overall traded goods for consumption). If a delicate balance of power and a stable democracy can be maintained, Myanmar and the region have much to gain.

5. Inequality is growing in the US – but may now go into reverse

The US Commerce Department released an update of its median wealth and income statistics, showing that median wealth and income were back to levels seen in 1994, while only the richest cohort saw their lot improve. The report has promoted a debate on the role of equity in growth. For the past 20 years, the global economy has seen growth and inequality at the same time. This is likely to reverse in the coming decade as part of the overall shift to the left. On the one hand, growth is likely to be restrained by increased regulation and taxation – aimed at least partially at business. On the other, we have reached such extreme levels of income and wealth distribution that shifting purchasing power to the middle class could have a big net positive effect since they have higher marginal propensities to consume.

6. Landmark move towards globalisation of tax

The US reached an agreement with the UK, France, Germany, Spain and Italy on the implementation of FATCA (the Foreign Account Tax Compliance Act). This 2010 law effectively makes financial institutions around the world subject to US tax law. This is the first step in the globalisation of tax. The focus u+p to now has been on private individuals using offshore accounts. Agreement on FACTA may eventually be seen as the first shots fired in a global war aiming to curb use of offshore banking services for companies as well.

7. Bond markets are transformed

Holders of debt are not as secure as they thought. The year started with PSI (Private Sector Involvement) for holders of Greek bonds. Essentially, bondholders were forced to accept large losses on their bonds following the subordination of their holdings by the official sector. In addition, we have seen the rise of collateralisation through the use of covered bonds and the reliance of financing from the state. This further subordinates private sector bondholders.

We are likely to see a move to bail-in regimes whereby senior unsecured bondholders would experience losses on their debt holdings in the event that an institution is perceived to be at threat. This will increase the costs of raising the €2.7tn of long-term debt that Europe's banks will need to issue in order to comply with Basel III. The banks will be shedding assets for the foreseeable future.

8. ETFs' importance is rising – and dealers are in decline

Bond trading is moving slowly to the exchanges. Increased regulatory capital charges have caused dealers to slash their inventories of bonds – weighing on secondary market liquidity. At the same time, ETFs have mushroomed and now soak up much of the liquidity in primary markets. The volumes of ETF transactions have increased liquidity and reduced transaction costs relative to trading in single issues. Improved liquidity is driving investors into high-yield and emerging market bonds (via ETFs), boosting returns in these asset classes. In coming years, expect more bonds to be traded on-exchange bringing liquidity back to the market for single issues. With the rise of the ETF and the decline of the dealer, the landscape has changed permanently.

9. Important IMF shifts on austerity

The International Monetary Fund changed course during the year, arguing that austerity is self-defeating. The message has yet to get through fully to the Europeans, especially in Germany, but rising gloom over Europe's economy could cause a change of thinking in 2013, with the German elections in September a major factor. Greece remains in a tailspin. When you cannot devalue your currency, and everyone is pursuing a policy of demand reduction, it's no wonder that debt-to-GDP levels keep rising.

10. Wisdom in Washington over capital flows

The IMF has at last acknowledged that capital controls can make sense in certain instances to protect emerging economies from aggressive short-term flows. As Meghnad Desai points out on p.1, this could be the beginning of a new outbreak of wisdom in Washington. However, a lot of people around the world, inside and outside the fund management industry, may see this as a negative sign of creeping state control over capital markets.

11. Europe decides banking union – but it loses momentum

The EU Banking Union decided in June seems like a move in the direction of common sense. However, largely because of innate policy contradictions between Germany and France, as well as the difficulty of dealing with non-euro EU members with large banking sectors (notably Britain and Sweden), it's lost some momentum. Despite the deal agreed by European finance ministers in the early hours of 13 December, it's hard to see this now as a transformational event.

12. Central banks in Europe and the US become more activist

This year we saw 'the Draghi Put', under the so far still-not-fully-defined 'do whatever it takes' strategy, as well as the first steps towards the US Federal Reserve increasing its short term inflation target. Expect Janet Yellen, tipped to be Bernanke's eventual replacement, to increase her clout and help the Fed move to a policy framework targeting economic variables, a step prefigures by Ben Bernanke's 12 December statement. This will inevitably reduce US emphasis on inflation and increase the focus on supporting growth – a development that can be expected (on the whole, happily) to spread around the world.

IMF nods approval of capital controls *(... continued from page 1)*

Guido Mantega, Brazil's finance minister, has been complaining for a while about this. Eminent people such as Governor Zeti Akhtar Aziz of Bank Negara Malaysia and Rakesh Mohan, former deputy governor of Reserve Bank of India, have long argued – based partly on experience of the 1997-98 Asian crisis – for temporary capital controls to corral the excesses of free-wheeling financial markets.

At OMFIF's Second Asian Central Banks' Watchers Conference in Jakarta on 13 November, Bank Indonesia executive director Perry Warjiyo defended Indonesia's measures to control short-term speculative inflows and said it was time for Indonesia's voice to be heard more.

The antecedents for the move are impressive. When the IMF was set up at Bretton Woods, Keynes did not quite succeed in having a global currency nor in getting the surplus countries to be treated symmetrically with deficit ones. But the Fund did have stringent controls on capital movements in its framework. The gold-dollar standard was only feasible with capital controls. This was what US practised with respect to outflows in the late 1960s, and it spawned the Eurodollar market. When the fixed exchange rate regime collapsed in August 1971, the IMF embraced the polar opposite of its previous stance. Capital controls were anathema and anyone and everyone had to embrace capital convertibility.

Lacking any role in the exchange rate relations of the developed countries. IMF began policing the developing world. At the height of the debt crisis of the so-called Third World, the IMF preached the Washington Doctrine. Exchange rates should be depreciated as far as possible, no capital controls and balanced budgets. The IMF did nothing to enforce these virtues in the US or western Europe, but the lesser countries had to abide by the rules.

In the Asian crisis, the injunction against capital controls was too much for some countries such as Malaysia to bear. Countries began to invent suitable methods to stem inflows and outflows of hot capital. Chile, the poster boy of Chicago liberalism, adopted capital controls. The natives were revolting.

The erstwhile developing countries are now emerging economies, while the ruling countries on the IMF governing board are mired in debt. Regarding the rise of the emerging economies and the decline of the once powerful, the IMF was strangely irrelevant. Globalisation took care of that. Free markets brought, too, the nemesis of the financial crisis which IMF did nothing to warn against. Now the IMF has caught up with reality. Better late than never.

Turkish central bank capital inflow measures seen as model for others *(... continued from page 1)*

What the Central Bank of Turkey terms as 'unconventional monetary policies to maintain financial stability' are aimed at tackling financial imbalances, limiting short term flows, and ensuring balanced domestic credit composition.

One method is to vary the effective central bank funding rate within a 'corridor' by using daily liquidity management tools to curb potential surges in short term capital flows. For example, in a widening of the corridor through a reduction of the overnight borrowing rate, interest rates in overnight markets will be lower than policy rates, downward volatility of overnight market rates will increase and short-term capital flows will decrease.

Another instrument is through changes in reserve requirements, differentiated by maturities, with higher reserve requirements for short-term liabilities. Turkish banks are allowed to deposit foreign exchange or gold instead of Turkish lira reserve requirements. This facility provides the Turkish lira liquidity to the banks in a more permanent way and also supports Turkey's foreign exchange and gold reserves. This smoothes imbalances between foreign exchange supply and demand and operates as an automatic stabiliser. If capital inflows accelerate, the cost of foreign currency assets will decrease with respect to domestic assets. Banks will choose to keep reserve requirements in foreign exchange as long as it is cheaper. Borrowing costs will be lower in foreign currency, so banks will use this reserve option mechanism more. Capital inflows are deposited at the central bank, reducing appreciation pressure on the domestic currency.

Iwata ahead *(... continued from page 1)*

Toshiro Mutoh, a former top bureaucrat at the Ministry of Finance and Bank of Japan deputy governor, proposed as governor by the LDP in 2008, is likely to founder now, as he did then, on lack of backing from the DP.

Iwata, a 66-year-old economics professor and former BoJ deputy governor, is the only contender who has served in an important post under both LDP and DP administrations and can thus rely on both parties' support.

As director of the Cabinet Ministry research institute between June 2008 and September 2010, he straddled the LDP-DP switch in September 2009.

Iwata is known to favour some radical Abe ideas, such as setting up a Y50tn fund to purchase foreign bonds and weaken the yen. As BoJ deputy governor, Iwata voted against the increase in the policy interest rate from zero in 2006. Further endearing himself to Abe, in 2010 he wrote a book entitled 'Fighting Deflation'.

A further piece of evidence backing Iwata's candidature is that he has written research papers with Koichi Hamada, a Japanese Professor at Yale University, whom Abe recently praised for standing up against conventional BoJ policies. Buttressed by these credentials, Iwata's star has been rising, and he appears favourite for now. But politics more than economics will decide his destiny.

King's unease over imbalances

Relative lack of adjustment by Germany and other creditors

International unease is growing at the relative lack of economic adjustment by Germany and other European creditor nations, which is aggravating financial and social strains on the struggling debtor countries in the south. Highlighted by a speech on 10 December by Sir Mervyn King, Bank of England governor, this is seen as an unfavourable accompaniment to the otherwise beneficial, though painful, rebalancing of the European economy.

'There has been no agreement on the need for working together to achieve some element of rebalancing the world economy,' Sir Mervyn said. 'My concern is that in 2013 we'll see the growth of actively managed exchange rates as an alternative to the use of domestic monetary policy.' Particular attention focuses on the German current account surplus. According to latest projections from the Organisation for Economic Cooperation and Development, this will increase to 6.4% of GDP this year from 5.7% in 2011, as imports slow and German companies mount successful export campaigns outside the euro area. The Dutch current account surplus is forecast at 8.4% this year, but this at least represents a fall from the unusually high 9.7% in 2011.

The German surplus is only slightly below the pre-crisis high of 7.5% of GDP in 2007. Most other large countries with formerly badly skewed current account positions, including China, Japan, and the US, have now sharply lowered their external surpluses or deficits. The persistently high surpluses among Europe's creditor nations come at a time when sharp falls in domestic demand have reduced southern countries' previously unsustainably high current account deficits towards much better balance. The lack of counterbalancing developments in northern Europe is seen as a sign that solvent northerners in economic and monetary union are still not doing enough to help the south by boosting domestic demand.

The lack of counterbalancing in northern Europe is a sign that solvent northerners are still not doing enough to help the south.

Australia, Canada dollars upgraded

Change in IMF reserve currency composition data

The Australian and Canadian dollars, the world's leading commodity-based currencies, are being formally classified as official reserve assets by the International Monetary Fund, marking the onset of a multi-currency reserve system and a new era in world money.

In a seemingly innocuous yet highly portentous move, the IMF is asking member countries from next year to include the Australian and Canadian dollars in statistics supplied by reserve-holding nations on the make-up of their central banks' foreign exchange reserves. The technical-sounding measure, reflecting the reality of growing diversification of the world's $10.5tn of reserves, is likely over time to exert wide-ranging impact on world bond and equity markets. The changes will become apparent when the IMF releases forthcoming data in its Composition of foreign reserves (Cofer) series.

Expanding by two the list of officially-recognised reserve assets from the present five – the dollar, euro, sterling, yen and Swiss franc – signals a new phase in the development of reserve money. For most of the past 150 years, the world has had just two reserve currencies, with sterling in the lead until the First World War, and the dollar taking over as the prime asset during the past 100 years.

Sterling – although still the world's third reserve currency on IMF figures – has been in relative decline since the Second World War. The birth of the euro in 1999 has turned the European single currency into the world's No. 2 reserve unit, but it is now officially accepted that the dollar and the euro share their role with smaller currencies. Enshrining in official thinking a development that has already taken hold among reserve managers and on private markets is likely to promote further asset diversification.

Expanding by two the list of officially-recognised reserve assets from the present five signals a new phase in the development of reserve money.

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Threat of perturbation

Watching out for the monetary cliff

Stefan Bielmeier, Advisory Board

We call the severe US fiscal policy tightening threatened at the end of 2012 the 'fiscal cliff'. Far more worrying though, not just in the US but in all other major industrialised countries, is a much larger and more dangerous phenomenon: the 'monetary cliff'.

As we now know, after years of economic stimulus programmes and high budget deficits, sharp tax increases and expenditure cut-backs could lead to the US economy sliding into a new recession and thus 'dropping off the cliff' at the end of the year. Much depends on what the re-elected Obama administration and the Republican opposition manage to agree in coming weeks. But we should be well aware of the monetary danger too. This could seriously threaten the entire global economy. For in all the world's largest economies, monetary policy-makers see their primary duty as preventing the collapse of the economic cycle. So they have focused attention on supporting governments borrowing from the capital markets on extremely favourable conditions despite their nations' high indebtedness.

During the 2007-08 financial unrest central banks eased monetary policy on an unprecedented scale. In the course of the ensuing sovereign debt crisis, they then introduced a series of expansionary and often unconventional measures. As part of its 'quantitative easing', the Federal Reserve bought over $1tn in Treasury bonds. In this regard the Bank of England and the Bank of Japan were not far behind.

The European Central Bank decided in favour of 'extraordinary measures' such as ultra-long tender transactions to enable commercial banks in the euro area to continue buying bonds issued by their respective home countries. The ECB has also established its own portfolio of government bonds from crisis-hit countries. A few weeks ago it indicated to the financial markets that, with its so-called Outright Monetary Transactions programme, it would buy additional government bonds, if necessary on an unlimited scale, with programmes linked to debtor countries agreeing appropriate conditionality with European governments to push through structural reforms.

This policy has led to extremely low capital market interest rates worldwide. After deducting inflation, the classic bondholder is posting a loss, while governments are able to refinance their ever growing mountain of debt at favourable rates. How long can this trend persist?

There is an iron rule among investors: 'Never bet against the central bank'. To this extent, a speculative attack on the undoubtedly over-priced bond markets, say in the US and Japan, hardly promises much success. Yet the central banks rely crucially on public confidence. Without stable inflationary expectations, monetary policy goes nowhere. As soon as there is clear evidence of rising inflationary expectations, the massive expansion in liquidity could trigger a price spiral that can then be contained only at incredible cost. The central banks cannot allow things to go that far.

In other words, monetary policy-makers have no choice but to retain their focus firmly on inflationary expectations and thus on guarding their own credibility. They must be willing to act to dampen inflation at an early stage. It is not only consumer prices that play a role here. Inflationary expectations can rise, too, on the back of rising asset prices. We are already seeing such phenomena in parts of the equity, commodity and property markets.

For the ECB this could mean that in serious cases it would need to suspend a OMT programme if the country or countries concerned did not adhere to the agreements on structural reforms. Such steps could cause considerable perturbations in the markets and among politicians, as well as badly denting the economic cycle.

But action along these lines may be inevitable if central banks are to protect their own credibility. The financial markets should bear the warning signals firmly in mind.

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Plotting shifts in credit growth

Keep an eye on lending too

Gabriel Stein, Chief Economic Adviser

Since the Great Recession began, central bankers and policy-makers have been placing increasing emphasis on the need to spur lending. Credit growth, we are told, must be boosted to around the levels of 2007 to get the international economy going again. The world, indeed, needs to look at credit as one important indicator of the way the economy is moving. Even though broad money is the more important measure, credit expansion (or the lack of it) tells us a lot about demand patterns in different sectors.

One example of the focus on credit came in early November when the Bank of England announced it was reaching the end of the line for its bond purchases (quantitative easing) and would instead concentrate on its Funding for Lending Programme.

The authorities should ensure they do not concentrate on the wrong measure. Credit growth is important, but not all-important. Broad money developments are considerably more significant, not least because whereas an injection of credit may be a one-off, a rise in broad money is (almost) permanent. Broad money can be destroyed in only two ways; either by destroying deposits, usually by repaying debt, or by buying bank shares, since banks' holdings of cash is not included in money supply. But actual falls in the level of broad money are generally rare.

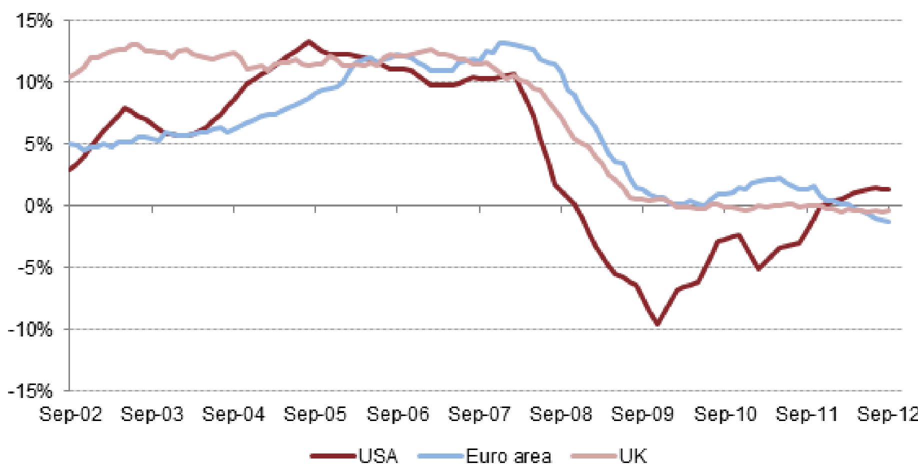
In reacting to recession, central banks should have done more to ensure steady growth of broad money, rather than concentrate on credit. It was always unlikely, after all, that over-indebted households or cash-rich companies were going to embark on a borrowing spree, particularly in a world of weak demand.

In reacting to recession, central banks should have done more to ensure steady growth of broad money, rather than concentrate on credit.

Despite these caveats, one of the reasons why we should look at credit is because it tends to be the most important counterpart to broad money. Moreover, credit developments can provide some pointers to the state of demand in different sectors.

Two points stand out from an examination of credit developments in the US, the euro area and the UK. (See Chart 1.) First, credit growth at double-digit rates in the years leading to the crisis was excessive (of course, this is not news). Second, developments since then have been highly diverse. Whereas annual changes in US bank lending switched from more than 10% growth in the autumn of 2007 to a 10% contraction two years later, the euro area and the UK experienced a much milder – though still severe – slowdown. In both these economies, credit growth went from more than 10% per annum to practically zero.

Chart 1: Credit to the non-bank private sector, 12-month change, %



Sources: Federal Reserve, Bank of England, ECB

US borrowers clearly deleveraged more than their euro area or UK counterparts. But whereas credit growth in both the euro area and the UK remains at or around zero, in the US it has picked up to between 1% and 2%. This is not impressive by past standards – in previous recoveries, credit growth would have been much higher at this stage – but it does provide a measure of economic support. In the euro area, credit developments are still deteriorating, with lending to the non-bank private sector falling 0.9% in the year to October 2012.

Whereas credit growth in both the euro area and the UK remains at or around zero, in the US it has picked up to between 1% and 2%. This is not impressive by past standards – in previous recoveries, credit growth would have been much higher at this stage – but it does provide a measure of economic support.

However, given the disparities within the single currency, headline data for the euro area as a whole are much less relevant than the national data, which show large variations by country. For these latter figures, it is best to use ECB data in preference to nationally sourced data, to facilitate international comparisons

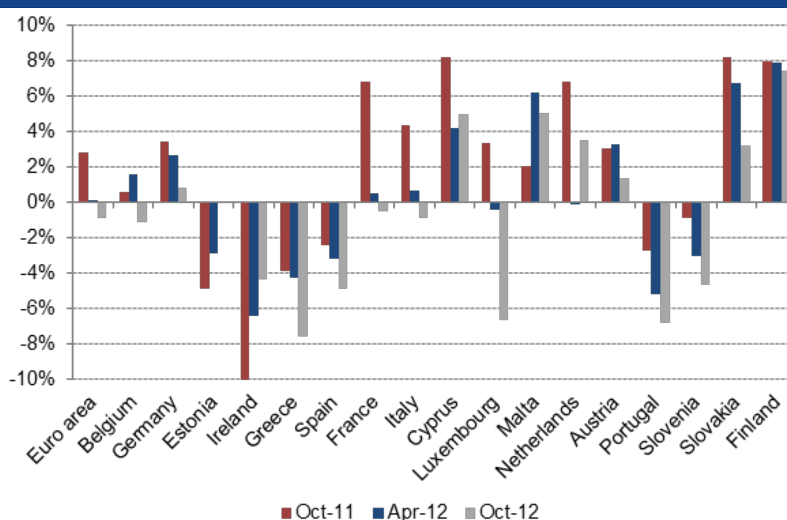
The national data in Chart 2 show two trends. First, credit growth differs sharply, with credit expanding in seven of the 17 countries (Germany, Cyprus, Malta, Netherlands, Austria, Slovakia and Finland) and contracting in the other 10. Second, even in countries where credit is expanding, it is generally doing so at a slower pace compared with a year ago (October 2012 compared with October 2011) and also six months ago.

As Chart 3 and 4 show, the trend of slower credit growth has clear been since late 2010/ early 2011. Overall credit numbers do not tell the whole story. For this, we need to look at borrowing by sector, focusing on loans to non-financial companies and to households, with the latter divided into housing loans and consumer credit. Although the overall pattern – stronger data in the US, weaker in the euro area and in the UK – also holds true here, there are some noticeable contrasts. The strength, such as it is, of US credit growth is primarily in corporate borrowing. Although this has slowed down in recent months, it remains around 12-13% on a twelve-month basis. By contrast, household borrowing, whether for housing purposes or consumer credit, is growing only at 2% to 4% per annum.

Across the euro area, loans to non-financial companies continue to contract; as do consumer credit loans. Housing loans, by contrast, are still rising, although only by around 1% and the trend remains weak. British credit developments are broadly similar to those in the euro area, although they have been less marked, notably by comparison with the slowdown in euro area home loans. (See Charts 5,6 and 7.)

There are multiple reasons behind divergent credit developments. US companies are currently cash-rich and so do not need to borrow, particularly as business survey data shows that they are unlikely to embark on major increase in capital expenditure in the near future. Moreover, they can still borrow directly from the capital markets, which to some extent is more attractive than bank loans. US households still need to deleverage, but not to the same extent as two or three years ago and are slowly returning to borrowing.

Chart 2: MFI loans to resident non-general government sector
12-month change to month shown, %



Source: ECB

The US exhibits an important contrast between credit and monetary growth – and this could lead policy-makers astray. Although the US credit numbers are more robust than those of the euro area or the UK, they are historically not particularly strong. As it happens, broad money numbers are stronger.

Since the Fed does not look at broad money but solely at credit, this is one instance where the divergence between the two could lead to mistakes. By concentrating solely on credit, the Fed may believe that the US recovery is weaker and less secure than is the case, and may therefore extend current monetary policy easing (or perhaps introduce new variants, no doubt to be known as QE4), even though this may no longer be necessary.

In the euro area, one problem for the European Central Bank in gauging the demand for and supply of credit – is that, in spite of the single currency, interest rates differ sharply across the single currency zone with regard to lending to non-financial companies in the largest economies, it is not clear how much of the difference between the growth rate of Dutch and Belgian corporate lending (respectively, 3.6% against 1.4% in the year to September, according to ECB data) is due to the fact that Dutch companies pay 3.5% for a loan in excess of five years and Belgian companies pay close to 3.9% for the same facility.

Intriguingly, French companies pay considerably more than Italian ones (3.4% against 2.9%), yet the example that has captured press attention is that Italian companies pay more than Austrian ones (2.6%).

The large interest rate spreads (more than 400 basis points) on corporate loans within the euro area (ranging from 2% in Finland to 6.2% in Cyprus) and on housing loans (250 basis points – 1.8% in Finland, 5.2% in Cyprus), is clearly a major problem. By comparison, five years ago, before the Great Recession, the differentials were 125 basis points for corporate loans and 250 for housing loans, differences which are more consistent with a 'true' economic and monetary union. However, it is difficult to see what the ECB can do about this, apart from decreeing single interest rates or maximum spreads for every loan category – and that would not work, nor would the ECB want to even try.

These euro area divergences are a secondary matter compared with the overall picture. The key message from recent credit data is that the US economy should continue to register positive growth beyond the end of 2012 and into 2013 (subject to a possible brief hiccup at the beginning of the year if the US falls over the 'fiscal cliff'), while the euro area economy will remain weak.

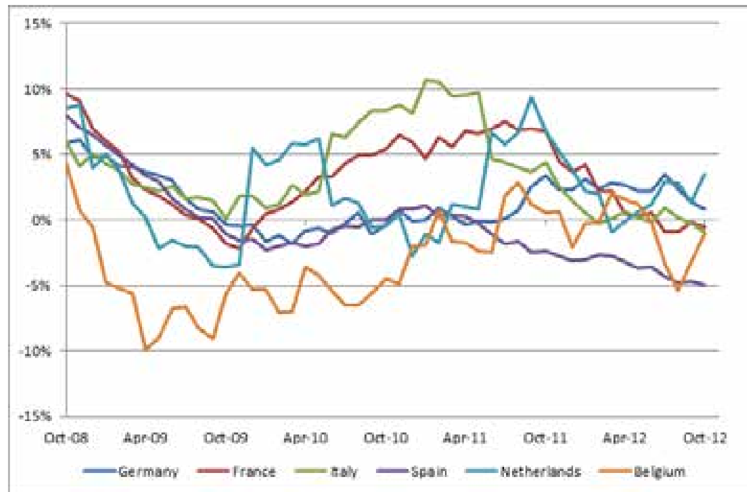
In the UK, credit growth is more reminiscent of the euro area; but output developments should be somewhat closer to the US, not least because British broad money growth, like that in the US, is more than 4%, rather stronger than credit growth. And at least the Bank of England knows the difference between money and credit.

The key message from recent credit data is that the US economy should continue to register positive growth beyond the end of 2012 and into 2013 while the euro area economy will remain weak.

Chart 3: MFI loans to resident non-general government sector 12-month change, %

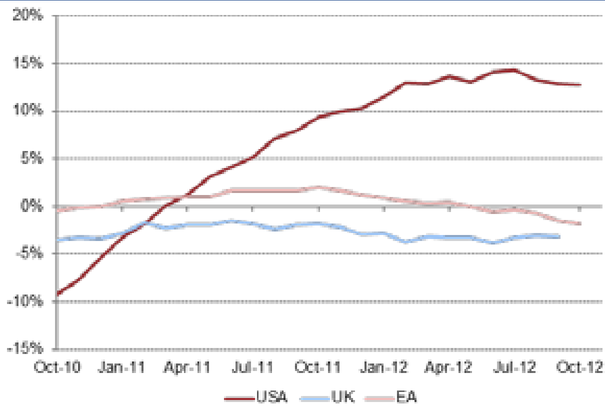
Source: ECB

Chart 4: MFI loans to non-financial companies 12-month change, %



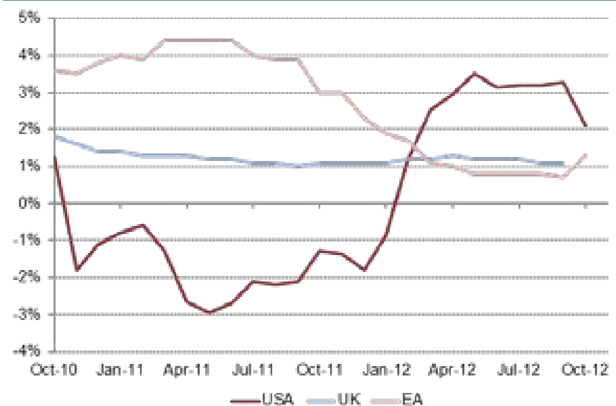
Source: ECB

Chart 5: Credit to non-financial companies, 12-month change, %



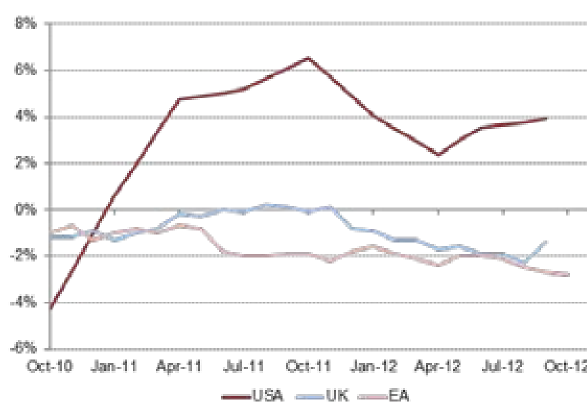
Source: Federal Reserve, Bank of England, ECB,

Chart 6: Credit to households for housing loans, 12-month change, %



Source: Federal Reserve, Bank of England, ECB

Chart 7: Consumer loans to households, 12-month change, %



Source: Federal Reserve, Bank of England, ECB

Going over Niagara Falls

Obama faces Basel III monetary headwinds

Steve H. Hanke, Advisory Board

If the timing is wrong, policy changes can create out-sized transition costs. It's what I call 'Niagara Falls Transition Troubles'. When asked to describe his experience of going over Niagara Falls in a barrel, the somewhat dazed daredevil said, 'Above and below the falls, it was calm, but the transition was a bitch.' Yes, transitions can be difficult. That's exactly where we are with Basel III – an ill-timed mandate to increase banks' capital-asset ratios.

Thanks to Basel III, newly re-elected Barack Obama is facing considerable monetary headwinds. The Obama administration, led by Treasury Secretary Timothy Geithner, has embraced the imposition of more stringent capital requirements on banks. It isn't alone. All the major powers have backed the use of Basel III bank capital requirements. These elevated bank capitalisation mandates, when applied in the middle of a slump, are misguided and dangerous. They have forced banks to deleverage on a massive scale. In consequence, bank money (the portion of the money supply created by the banking system) has contracted in most countries.

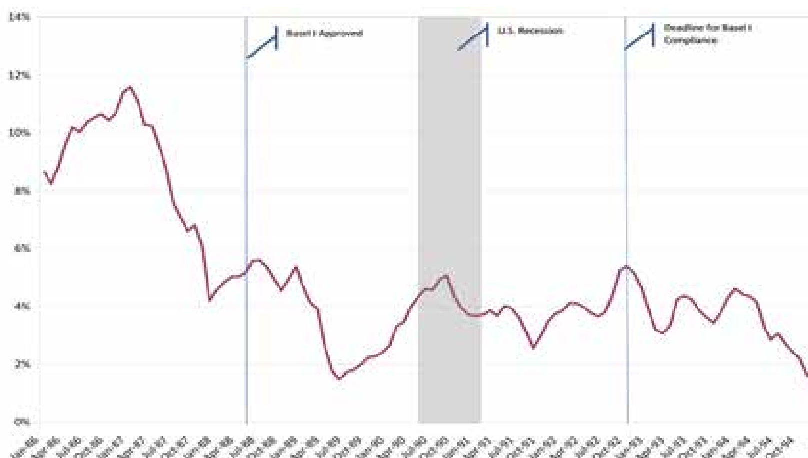
All the major powers have backed the use of Basel III bank capital requirements. These elevated bank capitalisation mandates, when applied in the middle of a slump, are misguided and dangerous.

Since this portion of the money supply is so much larger than that accounted for by state money (the portion of the money supply produced by central banks), the net result has tightened money in most countries – with a few exceptions, such as Canada, Germany, and several Asian countries. This explains why we are witnessing so many credit crunches at the same time as central banks are pouring out liquidity.

The Obama administration (and the Bernanke-led Federal Reserve) isn't the first to be caught wrong-footed by more stringent bank capital requirements. In 1988, Basel I was approved. It was supported by President George H.W. Bush and Fed chairman Alan Greenspan. As Chart 1 shows, the money supply growth rate slowed sharply in anticipation of the more stringent capital requirements, as banks reined in loan growth. The result was a mild recession; one that cost Bush a second term. In the case of both Basel I and Basel III, the illusion of 'safer banks' ultimately weakened the economy – and made the banks less safe.

Back to Basel III and President Obama's money supply woes. As Chart 2 shows, the Fed has dramatically increased the supply of state money (monetary base) since autumn 2008, when Lehman Brothers collapsed. But state money only makes up roughly 15% of total US money supply. Bank money is the elephant in the room, and due to the anticipation of more stringent capital requirements (Basel III), bank money has been contracting. In consequence, the total money supply (Divisia M4, excluding treasuries) has slumped, as Chart 2 shows.

Chart 1: Divisia M4, excluding treasuries (DM4-), year-on-year percentage growth

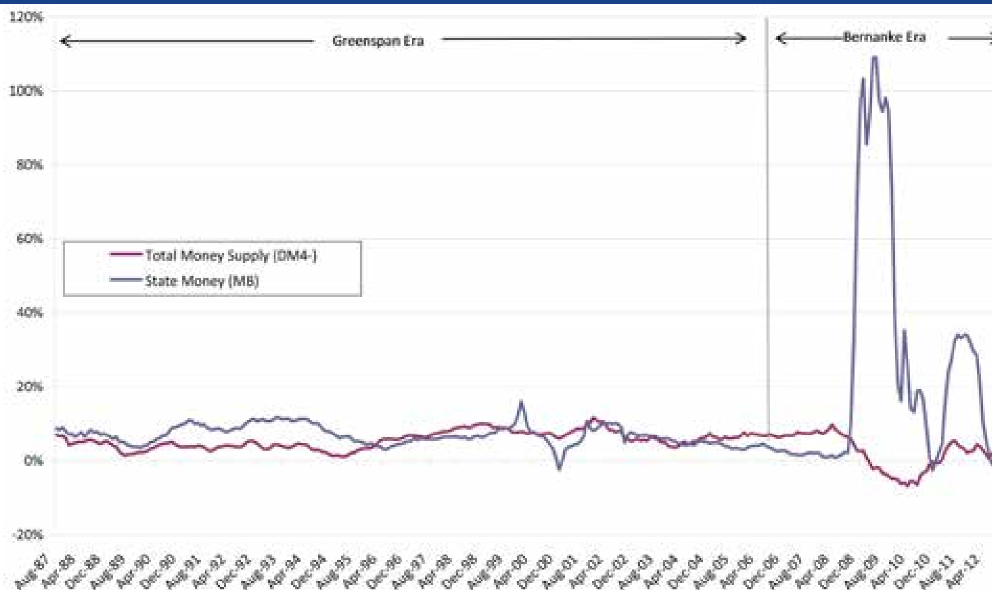


Source: Center for Financial Stability, author's calculations.

Thanks to Basel III, the US money supply isn't the only one creating growth headwinds. Europe faces significant money supply deficiencies (see Table 1). It's no surprise that the euro area has just fallen into a recession. When it comes to the money supply, just about the only bright spots are in Asia (see Table 2). Will Asia continue to be the world's locomotive? We will have to wait and see. The only thing we know for sure is that Basel III is taking the world over Niagara Falls.

It's no surprise that the euro area has just fallen into a recession. When it comes to the money supply, just about the only bright spots are in Asia.

Chart 2: Divisia M4, excluding treasuries, (DM4-) and monetary base (MB), year-on-year percentage growth rates since August 1987



Sources: Center for Financial Stability, Federal Reserve Economic Database, author's calculations

Table 1: Euro area money supply gaps

Country	Money supply gap	% Change needed to close gap
Euro area	543	6.01%
Austria	17	6.09%
Belgium	18	4.15%
Cyprus	9	18.66%
Estonia	0.3	2.89%
Finland	3	2.31%
France	80	4.40%
Germany	- 71	- 3.04%
Greece	77	50.23%
Ireland	62	35.99%
Italy	62	4.63%
Luxembourg	22	8.40%
Malta	2	16.78%
Netherlands	-1	- 0.15%
Portugal	25	17.23%
Slovakia	10	30.05%
Slovenia	4	19.81%
Spain	244	23.66%

Sources: Bundesbank, European Central Bank, author's calculations.

Note: The money supply gap = (total money supply) - (the trend level calculated from January 2003 to the latest available data point). Light blue cells signify a money supply deficiency. Grey shaded cells signify a money-supply surplus.

Table 2: Money supply gaps – select countries

Country	Money supply gap	% Change needed to close gap	Money aggregate
Canada	- $13.8bn	-0.88%	M3
China	- ¥10.0tn	-10.85%	M2
Hong Kong	- $0.3tn	-3.54%	M3
Indonesia	- Rp311.0tn	-10.18%	M2
Japan	- ¥26.1tn	-2.32%	M3
Singapore	- $6.7bn	-1.43%	M3
Taiwan	NT$0	0.00%	M2
UK	£275.7m	12.07%	M3
US	$1.0tn	6.76%	M3

Sources: Bank Indonesia, Bank of England, Bank of Japan, Central Bank of the Republic of China (Taiwan), Federal Reserve Bank of St. Louis, Hong Kong Monetary Authority, International Monetary Fund, Monetary Authority of Singapore, shadow government statistics, and author's calculations.

Note: The money supply gap = (total money supply) - (the trend level calculated from January 2003 to present). Light blue cells signify a money supply deficiency. Grey shaded cells signify a money-supply surplus.

Fed mulls unemployment target

Using outcome instead of date as signal for policy shift

Darrell Delamaide, Board of Contributing Editors

The US Federal Reserve has made a major change to economic policy by announcing it will keep interest rates at close to zero until unemployment falls below 6.5%. The policy shift, the culmination of months of discussion on moving to a more explicit unemployment target, is likely to have a significant impact on policies at other central banks around the world, including in the UK and Japan where leadership changes take place next year.

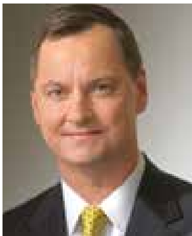
Fed Chairman **Ben Bernanke** told a press conference on 12 December that the new policy would support household and business confidence and make monetary policy 'more transparent and predictable.' The announcement follows several months in which Federal Reserve officials have been 'picking a number' as they debate whether to tie monetary policy to threshold figures in unemployment and inflation. While the official target rate for inflation is 2%, some members of the Federal Open Market Committee are willing to overshoot as far as 3% if the unemployment threshold has not been met. On 12 December Bernanke spoke of keeping rates low as long as its inflation forecast stayed below 2.5%.

Janet Yellen

Fed Vice Chairman **Janet Yellen** (voter) lent momentum to this paint-by-number monetary policy in a mid-November speech that was immediately labeled a 'game changer' by some Fed watchers. In a long speech at Haas Business School in Berkeley, where Yellen taught for much of her career, she discussed the evolution of the Fed's communication policy towards more transparency.

Other Federal Reserve officials have been 'picking a number' as they debate whether to tie monetary policy to threshold figures in unemployment and inflation. Unemployment numbers, for instance range from 7-something to 5-something.

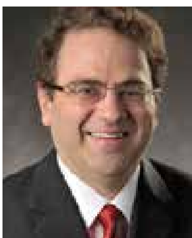
Calendar dates would be subject to change if the economy should unexpectedly take off. So, foreshadowing Bernanke's statement, Yellen suggested a further step: 'The Committee might eliminate the calendar date entirely and replace it with guidance on the economic conditions that would need to prevail before lift-off of the federal funds rate might be judged appropriate.' She noted that some FOMC members had recommended such an approach.



Charles Evans

Chicago Fed chief **Charles Evans** (2013 voter) was the first to suggest that rates be held study until unemployment, currently at 7.9%, reaches 7%, as long as core inflation remains below 3%.

Minneapolis Fed President **Narayana Kocherlakota** (non-voter) suggested a lower unemployment number, 5.5%, but was stricter on the medium-term inflation outlook of 2.25%. This would all be guidance, not rules set in concrete. 'Under such an approach, lift-off would not be automatic once a threshold is reached,' Yellen said. 'That decision would require further Committee deliberation and judgment.'



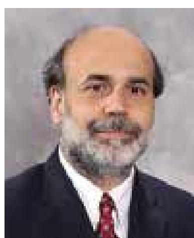
Narayana Kocherlakota

After a year of pushing for his 7/3 targets, Evans said in a late November speech in Toronto that conditions have improved and he now thinks 6.5% is more a reasonable threshold to signal a change in monetary policy.'If we continue to have few concerns about inflation along the path to a stronger recovery there would be no reason to undo the positive effects of these policy actions prematurely just because the unemployment rate hits 6.9%,' Evans said, noting that is still well above what anyone would consider maximum employment.

Evans added that the inflation threshold would also be lower, especially given the subdued level of price pressure. 'We're much more likely to reach the 6-1/2% unemployment threshold before inflation begins to approach even a modest number like 2-1/2%,' he said.

Evans rotates into a voting position on the FOMC in 2013. Along with the transition of fellow super-dove **Eric Rosengren** of Boston into a voting slot and the addition of two dovish-leaning members to the Board of Governors (who always get to vote), **Jeremy Stein** and **Jerome Powell**, the committee is likely to be even more dovish in 2013 than it was in 2012, a fact that has not been lost on Fed watchers observing the changes in FOMC composition.

These changes may become apparent in voting behaviour in the next few months. This will be only partially offset by the addition of the other new voters in 2013 – **James Bullard** of St. Louis, generally slotted in the middle of the road, and **Esther George** of Kansas City, who is spreading her wings as a hawk.


Ben Bernanke

Added to this is the general view that Yellen has the inside track to replace **Ben Bernanke** as chairman when his term expires at the beginning of 2014. This will give Yellen more influence as the year progresses and Bernanke becomes a lame duck. The actual announcement could be as early as the summer.

So Yellen has a lot of support in moving ahead with these threshold targets. Even one of the FOMC hawks, Dallas Fed president **Richard Fisher** (non-voter), recently expressed guarded support for the idea of setting an unemployment target as he called for setting some limit on the Fed's asset purchases rather than leaving them open-ended.

'One option I believe we might pursue is to have a definition of our unemployment target as well as our long-term inflation target,' he said in a speech in Berlin. His own preference, however, was to set an overall limit on the asset purchases themselves since monetary policy alone cannot necessarily influence unemployment. However, this anti-inflation hawk went on to add: 'I am not worried about inflation right now; I am worried about an underemployed workforce in America.'

'Crisp numerical thresholds may work well in the classroom models used to illustrate policy principles, but one or two economic statistics do not always capture the rich array of policy-relevant information.'

Jeffrey Lacker

Super-hawk **Jeffrey Lacker** (2012 voter) of Richmond, however, did not hesitate to dissent on giving specific threshold targets. 'The Committee could provide some sense of the economic conditions under which it's likely to begin raising rates and reducing the size of its balance sheet,' Lacker said at a symposium of the decidedly hawkish Shadow Open Markets Committee in New York.

'But it's important to avoid spurious precision.' Lacker, who is finishing up his year as a voting member, said that any single indicator might be misleading. 'Crisp numerical thresholds may work well in the classroom models used to illustrate policy principles,' he said, 'but one or two economic statistics do not always capture the rich array of policy-relevant information about the state of the economy.'

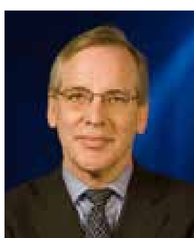
Tackling 'too big to fail'

On another issue, a pair of recent speeches indicates some debate within the Fed about the effectiveness of the regulatory response to the financial crisis and whether the question of 'too big to fail' banks has really been dealt with.

At a high-level meeting of bank supervisors in Panama, Kansas City's George wondered aloud whether the actions taken have left unresolved issues.

'We should first ask ourselves if we have corrected the misaligned incentives that were behind this crisis,' she said. The rush to protect big banks from failing at all costs was controversial in the US and elsewhere she noted. 'We cannot expect to have a sound financial system if the key players in it are not held fully responsible for the choices they make.'

Some of the new measures may actually reinforce the sense of too big to fail and may encourage banks to take on more risk, not less, she warned. 'Enhanced supervision and the related steps many of us are taking now are unlikely to work well as long as major institutions still have incentives to take on added risk,' George said.


William Dudley

New York Fed chief **William Dudley** (voter) said it was too early to tell whether the current policies of 'reducing the incentives for firms to operate with a large systemic footprint' are working or not.

While some are advocating a simple breaking up of the big banks, Dudley favoured giving the current approach more time. 'But, if we fail to reach our destination by this route, then a blunter approach may yet prove necessary,' he added.

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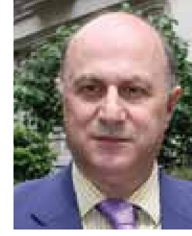
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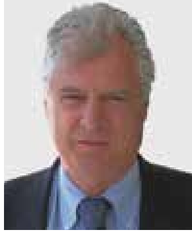
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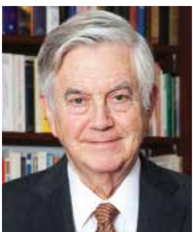
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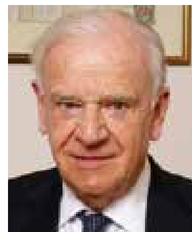
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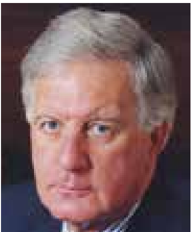
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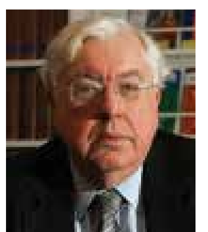
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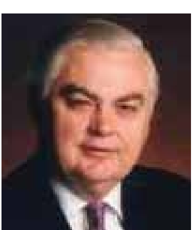
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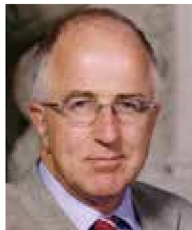
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OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome Jean-Claude Bastos de Morais, founder of Quantum Global Group, African Innovation Foundation and Banco Kwanza Invest; John Chown, founder of Chown Dewhurst LLP; Hemraz Jankee, former Director of Research at Bank of Mauritius; Davide Leone, founder of Davide Leone & Partners Investment Company LLP; Anthony Robinson, former East Europe editor and Moscow correspondent of the Financial Times and Takuji Tanaka, Executive Managing Director, Innovation Network Corporation of Japan. This takes the total number of Advisory Board members to 117. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

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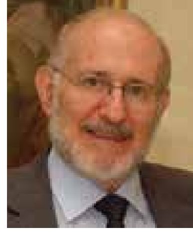
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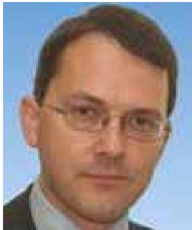
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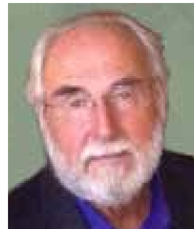
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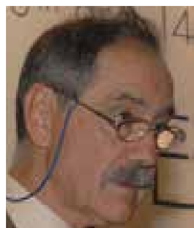
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Relative optimism on Africa economy

Progress depends on better prospects in emerging markets, US

The Second OMFIF Meeting in Africa, held at Bank of Mauritius in Port Louis on 6-7 November, concluded that the African economy was in relatively good shape – but progress in coming years would depend crucially on developments in the other emerging market economies and the US. Europe, by contrast, was felt to be languishing in the doldrums for some time to come.

The recession in Europe was viewed as a particular problem for Mauritius, in view of close trade links between Mauritius and the Old Continent.

The themes of the meeting included: shifting trade between Asia and Africa; the role of sovereign funds as new investors in Africa; the outlook for infrastructure investments; identifying needs, priorities and financing options; technology and telecoms growth in African economies.

Further issues were governance and growth as the key to economic transformation; opportunities to deepen mutually beneficial south-south cooperation and the role of Latin America, the Middle East and Asia in African development.

Discussions at the seminar,which brought together 94 delegates from 61 institutions (not counting OMFIF) from 26 countries, can be grouped into three main areas:

1. World economic environment including outlook for the US, Europe and emerging markets

The US was held to be in a much better position than Europe. Emerging market economies were seen as not growing fast enough to assure fully-sustainable African expansion.

In 2007, and again immediately after the financial crisis, China, India and Brazil provided the engine for world growth. In 2012, however, these countries do not seem to be so well-positioned to play that role, as previously gallopping growth rates have seen a sharp decelleration.

These countries are important markets for African commodities exports. A concerted effort by the US and Europe to pull the world out of recession or near-recession and on to recovery was badly needed, but because of the extent of deleveraging required after the 2007-08 crisis, this kind of joint policy response did not appear to be imminent.

In view of the lack of room for fiscal manoeuvre by many governments, central banks in industrialised countries are bearing the brunt of efforts to promote growth through expanding their balance sheets, but there were doubts about how long this would last.

The worries over the worsening economic outlook in Europe coincided with a relatively gloomy picture for recovery in the US, reflecting concern whether the government can escape the 'fiscal cliff' of sharply rising taxes and falling spending next year as part of efforts to rein back the budget deficit.

2. Africa economic future and requirement for more integration

In line with the findings in Pretoria in August 2011, world-wide interest in and demand for African investments are growing rapidly as a result both of positive fundamental changes in Africa and of the more pessimistic outlook in the rest of the world, especially Europe.

However there was also intensive focus on the existing barriers to African growth, including grave shortcomings regarding protectionism, corruption, infrastructure and education.

Driving forward African integration in trade, investment and capital markets, and allowing this movement to build up self-generated momentum that would make Africa less vulnerable to economic vicissitudes elsewhere, was an important area of discussion. Several delegates said this was one of the most important issues for the future.

There was general agreement that the rise of China and competition for African resources were positive factors for African development.

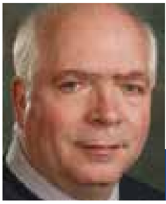
Although some delegates opined that the 'vision' of a grand plan for Africa needed to be kept alive, this was balanced by an opposing belief that setting targets and forging partnerships among a smaller number of relatively homogenous and/or regionally contiguous nations on a regional basis would be a better option.

3. The rise of south-south cooperation and shifts in world economic governance

Two regions, namely Asia and Africa, are growing faster than the world average GDP, resulting in a multi-polar world. South-south cooperation is becoming increasingly important and this trend is bound to continue. Despite the disappointing performance of Europe, this multi-polar state of affairs was generally seen as a better model than reliance on the US engine of growth.

With regard to world economic governance, several participants pointed to insufficient progress in increasing the voice of developing and emerging market economies at the International Monetary Fund and World Bank. However, changes were taking pace, as seen in the growing importance of Chinese nationals in international financial organisations, such as the IMF, the World Bank and its soft loan affiliate IFC.

There was general emphasis on the important role of education in nurturing growth in the south, together with the related areas of building effective human capital and sustainable infrastructure.



Profiting from long-term thinking

Strategies to ride out short-term pressures

Darrell Delamaide, Board of Contributing Editors

Short-termism and the pressure it puts on market participants at all levels can be the nemesis of long-term investors like sovereign wealth funds (SWFs). But these pressures also represent a good reason why they were set up, since they have the size and protection to ride out short-term fluctuations and benefit from long-term value creation.

As one of the participants at the conference said, 'It's rare to find a good chairman running a bad company.'

The volatility produced by short-term actors challenges the investor taking a long view to balance between momentum and value, according to participants at a recent conference at Columbia University in New York. Speakers and panellists proposed solutions to this quandary ranging from the introduction of 'loyalty shares' for rewarding long-term investors to a better understanding of the time lags involved in assets shaking off irrational market behaviour.

The conference, 'Long-term investing: An optimal strategy in short-term oriented markets,' was organised by the Committee on Global Thought at Columbia and the Sovereign Wealth Fund Research Initiative (SWFRI). Speakers included academics like Nobel Prize-winner Joseph Stiglitz as well as practitioners. 'Extrapolation – that past trends will continue – is the main inefficiency in the stock market and is responsible for momentum trading,' said Jeremy Grantham, chief strategist at the asset manager GMO in Boston. 'Everything will return to fair value – it's the timing that's uncertain.' Grantham quoted John Maynard Keynes' dictum that markets can stay irrational longer than a client can stay solvent, but said long-term investors like SWFs were able to prove Keynes wrong.

The stock market may actually be less volatile than it seems, David Laibson of Harvard University said. Equities almost invariably revert to the mean, but it can take much longer than many expect: more likely 10 years rather than the five year maximum often put forward. As a result, many investors 'radically misperceive the riskiness of volatility,' Laibson said, by a factor of nine – an argument for giving greater weight to equities.

Some long-term investors have come to the same conclusion, according to SWF executives. Norway's sovereign wealth fund shifted the equities portion of its portfolio to 60% from 40% in the four years after the onset of the 2007-08 financial crisis, Pål Haugerud of the Norwegian Finance Ministry said, enabling them to recoup some losses engendered by the crisis. Mats Andersson, chief executive of the Fourth Swedish National Pension Fund, said his fund is required by law to maintain 60% in equities. The New Zealand Superannuation Fund has undertaken a 'strategic tilting' in favour of equities, chief executive Adrian Orr said, lowering its allocation to bonds.

Some speakers, however, saw the need as well for institutional changes to combat the pressures. Patrick Bolton of Columbia University and Frédéric Samama of SWFRI presented a case for creating 'loyalty shares,' perhaps in the form of warrants granted to existing shareholders that could be exercised after three years for a period of three years.

The effect of a corporate culture of sustainability on corporate behaviour and performance outcomes was the subject of a presentation by Robert Eccles of Harvard Business School. In a matched sample of 180 companies, Eccles and his co-researchers found that corporations that 'high sustainability' companies significantly outperform their 'low sustainability' counterparts over the long term in both stock market and accounting performance. The practitioners affirmed the relevance of this correlation in practice. Sweden's Andersson said he doesn't believe in 'positive investment' for its own sake, but because the return is better. Likewise, he said, his strategy is focused on individuals. 'It's rare to find a good chairman running a bad company,' he said. In the end, some participants said, long-term investing is not that different from short-term investing, except for taking the long view. 'It's a fallacy to think of long-term investing as "buy and hold,"' said Andrew Ang of Columbia Business School. 'It means constantly trading.'

Looking ahead to 2014 for respite

Weakening European economy at year-end

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013	2014
US	1.8	2.2	2.0	3.0
Japan	-0.7	1.7	0.7	1.3
China	9.3	7.8	8.5	8.7
Euro area	1.5	-0.4	-0.3	1.3
Germany	3.0	0.9	0.4	2.2
France	1.7	0.1	0.2	1.0
Italy	0.5	-2.5	-0.9	0.7
Spain	0.4	-1.6	-2.2	0.9
UK	0.9	-0.2	0.4	1.5
Addendum				
Asia excl. Japan	7.4	6.2	6.9	7.3
World	3.6	3.1	3.2	3.9
Consumer prices (% y/y)				
US	3.6	3.1	3.2	3.9
Japan	-0.3	0.0	0.1	0.2
China	5.4	2.6	3.2	4.2
Euro area	2.7	2.5	2.5	2.5
Germany	2.5	2.1	2.1	2.6
France	2.3	2.2	2.3	2.4
Italy	2.9	3.3	2.4	2.4
Spain	3.1	2.5	3.5	2.5
UK	4.5	2.8	2.4	2.7
Current account balance (% of GDP)				
US	-3.1	-3.2	-3.1	-3.2
Japan	2.0	1.0	1.2	1.7
China	2.8	2.5	2.6	2.1
Euro area	0.0	0.2	0.2	0.5
Germany	5.7	5.9	4.3	3.9
France	-2.0	-2.3	-2.2	-2.0
Italy	-3.3	-2.2	-1.8	-1.8
Spain	-3.5	-2.7	-2.0	-1.8
UK	-1.9	-3.0	-2.5	-1.8

Produced in association with DZ Bank group, a partner and supporter of OMFIF

The general easing of financial markets' concerns over the euro crisis has continued in the past few weeks, helped by European governments' agreement in November to continue financing Greece. But once again we are left with the impression that Greece's funding gap has not been closed for good and that this is yet another merely temporary solution.

The success or otherwise of the planned debt buy-back in December will provide an indication of whether the euro crisis navigates imto calmer waters or faces renewed storms in the run-up to Christmas.

Latest economic data from the euro area have tended to come in on the weak side, though there have been some positive surprises. The EU Commission's monthly confidence indicator showed a small rise in November after a string of eight declines.

Although consumers remain pessimistic, the latest figures show the business climate has improved slightly in manufacturing and retailing.

This is further confirmed by the improvement in Germany's Ifo business climate index. Though this doesn't amount to a trend reversal, it has at least interrupted the steep downtrend of recent months.

From an economic point of view, we expect the European winter half-year to be a hard one. Germany's growth is likely to come to a standstill while the euro area as a whole will remain in recession.

The first signs of a gradual recovery will probably only come through during the course of next year. The German economy will be able to benefit from better performances in the US and China.

Full-year 2013 growth in Germany will however remain extremely weak. Only in 2014 is the German economy likely to return to dynamic growth, fuelled by a good export performance and strengthening corporate investment. In most of the crisis-afflicted euro area countries, 2014 should finally bring the end of the long and deep recession.

In China, there are increasing signs that the economy has bottomed out and growth is gradually gathering pace. For the final quarter of this year we expect a somewhat higher growth rate than in the summer months, but overall growth this year will probably stay below 8%.

For 2013, we expect growth of an average 8.5%, slightly lower than previously forecast. In 2014, growth should accelerate with increasing global activity supporting China's export sector.

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Giving up German power

What happens when hegemony ends

Mojmir Hampl, Deputy Governor, Czech National Bank

Before the euro's formation, Germany was frequently seen as Europe's monetary hegemon. Economic and monetary union (EMU) was an attempt to overcome that state of affairs, and share out monetary influence on a fairer basis. The process has however led to frustration from two different sources. All of Europe is suffering from the consequences.

Germany has been discomfited by the practical unenforceability of the rules on good behaviour it demanded in return for losing its previous status. Germany's loss of control over its own monetary destiny enabled other countries previously jealous of its power to free-ride the new system. Yet the countries which wanted to (and did) deprive Germany of is status have been equally frustrated. Changing the monetary system did not prevent them from suffering the consequences of bad national economic policies. These consequences have taken a different form compared with the past; some of them are worse than before. These two sets of negative emotions have a common root. They both stem from misunderstanding of fundamental economic paradigms, from lack of appreciation that, ultimately, economic principles triumph over mere politics.

Countries with the greatest fear of the disciplining power of the market, those which most fiercely want to do away with it, are probably the least qualified to join a single currency club. In the same way, one might say that, if a hegemon does not want to lose its status, it should never compromise on it. The future of EMU depends crucially on German attitudes. Germany has to decide through a public decision-making process whether it wants to continue with a landmark project of European political integration, or to maintain a universally admired currency with the credibility and status of the D-Mark.

Up until the onset of the euro crisis, it seemed possible for Germany to enjoy both sets of circumstances, but in the long term only one is possible. A pattern of external and internal rules makes these two outcomes dynamically incompatible. This is a fundamental choice. Had the euro not been created, we can only speculate whether the D-Mark would now be an even stronger monetary power than before 1999. Such a theoretical scenario is not beyond the realms of possibility.

But many more issues are at stake. Can the concept of an independent central bank, one that does not fund government liabilities on demand, survive the crisis? Will Germany behave in the future more like a consumer of the public good named the euro, and less like its sponsor? Can Europe reinforce, repair and reconstruct a fragile single currency structure which has been largely built from the roof down, not from the ground up? One thing is certain. If the previous hegemon of European money really wanted to avoid such painful questions and consequences, then it made an enormous mistake by joining EMU in the first place.

The direct and indirect costs of this fateful decision are incalculable, since they are completely open-ended and have grave repercussions on Germany's neighbours. Those who call for Germany's influence to be weakened or subsumed must realise that the demise of a former European hegemon can only lower the quality of the public good of monetary stability and a sound currency. That's a warning, too, for those countries, like the Czech Republic which have not yet signed up to EMU. There is no historical precedent for the euro's institutional set-up. Despite this, it is an arrangement that could not and cannot escape the universal principles of economics. As a result of the route taken, Germany's monetary hegemony more or less came to an end. The consequences of that fall from hegemony live on, within and beyond Germany.

Those who call for Germany's influence to be weakened or subsumed must realise that the demise of a former European hegemon can only lower the quality of the public good of monetary stability and a sound currency.

This article is an edited extract from an essay in January 2013 in the German Economic Review.

Wider powers, greater restraints

A new balance for world central banking

Philip Middleton and John Plender, Advisory Board

Finding a balance in the new landscape for worldwide central banking is fraught with real and potential conflicts of interest, all with large repercussions for central banks' accountability and independence. Hanging over the central bankers is a spectre that has been prevalent throughout the history of official monetary policy, and especially during the financial crisis: moral hazard, or the development of counterproductive incentives that promote rather than hinder destabilising behaviour by financial market participants.

This is an especially large issue regarding the political, economic and legal tussle surrounding Economic and Monetary Union and over the status and remit of the European Central Bank.

These differences of emphasis about credit policies in Europe are part of a wider central banking debate in which opinion around the world has moved toward greater pre-emptive stringency, adapting to signs of excess monetary growth and asset price bubbles through 'leaning against the wind' earlier in the credit cycle.

There is plenty of room for conflicts of interest between previously separated operational structures of financial and monetary stability, now being brought together in a way that, in many cases, amounts to reversion to an old form of central banking architecture. For example, the tightening of capital requirements for banks under Basel III at least partly contradicts the need to prompt recession-defeating flows of bank funding.

There is plenty of room for conflicts of interest between previously separated operational structures of financial and monetary stability, now being brought together.

The separation or 'ring-fencing' of retail commercial banking structures to protect them from risks in investment banking has been put forward in some countries, predominantly the US and the UK, as a way of avoiding the need for taxpayers to bail out risk-prone banking operations. (It should be noted that investment banking is not necessarily or inherently riskier than retail banking; the first bank to fail in the financial crisis was the British retail bank and former building society Northern Rock.)

The upheavals in the central banking landscape have substantial repercussions in the sphere of politics and public opinion, as shown in the US, Europe and Japan, as well as in emerging market economies. The substantial upgrading and widening of central banks' roles have taken place while they have maintained a high degree of statutory independence from governments, part of a compact to preserve their freedom of monetary policy action and guard against irresponsible and inflationary government policies.

Politicians' scrutiny and control rights over central banks' actions have, however, not increased in line with the considerable expansion in central banks' realm of action and de facto power. This has sometimes given rise to searching debates about democratic accountability.

Central banking in emerging market economies, too, has undertaken an important transition as a result of the general pressures on economic policies in recent years. Yet these changes have been less radical than in the industrialised nations. As they have come of age in the past two or three decades, central banks in emerging market economies have been traditionally closer to the core of government, more prone to government influence, and holding sway over a greater variety of economic and social tasks, often involving national development goals.

Since the impact of the trans-Atlantic economic crisis on these countries has been less acute, and since their central banks already commanded a relatively wide field of action, they have not been confronted with the operational widening that has been such a challenging transition for western central banks.

Shortcomings displayed by central banks – and subsequent pressures on their independence – have been epitomised by Alan Greenspan, widely praised during his 18 years as Chairman of the Board of Governors of the US Federal Reserve. Ben Bernanke, his successor, himself a governor of the Fed from 2002 to 2005 before he took over as Chairman in February 2006, has faced a political backlash that has been all the fiercer because of the unquestioning enthusiasm that preceded it.

The shift in opinion on the necessity and efficacy of independence is part of a steady historical pattern: a changing carousel of central banking doctrine.

The debate over the role of the Fed and other central banks underlines how the threat to independence is very far from being a matter of theoretical dispute: it has entered into the realms of Realpolitik. According to Jamie McAndrews of the New York Federal Reserve, 'In many countries, central bank independence is at risk. The use of unconventional tools is difficult to explain, and the discussion around central bank actions has been increasingly coarse and uninformed. This represents a major risk to central banks.'

Marek Belka, President of the National Bank of Poland, sees central bank independence endangered by 'the blurred line dividing monetary and quasi-fiscal actions of many central banks during the crisis,' driven by what he calls the 'unpleasant arithmetic' of very high public debt. Further risks stem from difficulties in 'efficient implementation of institutional structures covering both monetary policy and macroprudential policy mandates' as well as in 'fulfilling the price stability mandate in the current international environment,' which is characterised by QE extensions and greater volatility of financial flows. 'This issue is particularly pertinent for emerging economies.'

In a sense, it is not surprising that the historically somewhat anomalous position of statutorily autonomous central banks is now under pressure. The ECB's independence is still more solidly embedded into law than that of the German central bank, since it is part of an international treaty. But as a result of compromises with governments caused by the strains confronting EMU, the high-water mark of ECB independence may now have passed.

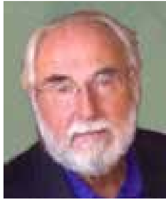
Prof. Niels Thygesen of Copenhagen University, a member of the OMFIF advisory board, says the ECB in its first years of existence probably exaggerated its independence. 'The idea of the central bank as it was set up at Maastricht was a very pure sort of central bank. It was not going to get involved in supervision. It would not be involved in foreign exchange operations. It should not be overly concerned with economic policy throughout the euro area. It would be isolated from EMU political authorities. But it has become increasingly obvious that the greatest threat to the ECB's independence is to be alone on the stage. So the ECB has inevitably to accept a less pure form of independence where it can be a counterparty to dialogue with the political authorities.'

According to Lord Desai, emeritus professor at the London School of Economics and chairman of OMFIF's advisory board, the shift in opinion on the necessity and efficacy of independence is part of a steady historical pattern: a changing carousel of central banking doctrine. Now, he says, the world is moving to a new form of central banking multilateralism.

Desai is somewhat cynical about the lags in the central banks' reactions to changes in the economic or political environment. 'Generals fight the last war, and central banking tends to follow suit. After the Great Depression, the world agreed to abandon the gold standard and orthodox monetary policy. During the era of fiscal policy leading monetary policy, central banks became adjuncts of the Treasury. Then after the Great Inflation of the 1960s and 1970s, we had monetarism, with central banks pursuing money supply targets. After that, the success of the Bundesbank became an object of international regard. So the worldwide norm became independent central banks following inflation targets.'

But now, Desai says, the constellation is changing again: 'Free-standing central banks pursuing their own national agenda are on the way out.' Precisely what will take their place is, of course, a matter of conjecture.

This article is an extract from a joint report by OMFIF and Ernst & Young, 'The financial crisis and its aftermath – Challenges for central banks: wider powers, greater restraints'.



Greeks fear another Katastrofi

Euro debt crisis seen as worse than 1922

Anthony Robinson, Advisory Board, recently in Athens

As the euro debt crisis drags on, Greeks are starting to compare their dire straits to the Katastrofi of 1922. In that tragic year a bungled invasion of Turkey ended with a massacre of Greeks in Smyrna, followed a year later by the forced repatriation of Greeks from Asia Minor and a matching expulsion of Turks from Greece. Historian Thanos Veremis of the Hellenic Foundation for European and Foreign policy thinks that, from the financial point of view at least, now is worse. 'Repatriation, though terribly painful, sparked off an economic boom as the new people sought to rebuild their lives and their wealth.'

Even the two previous drachma defaults had their silver lining. The 1893 default under premier Harilaos Trikoupis, elected to parliament thanks partly to the votes of diaspora Greeks in Manchester, was hardly noticed in what was still a pre-modern, self-sufficient and largely peasant country. What is more, the foreign loans were well spent on infrastructure. The second default in 1932, against the background of a global recession, caused imports to drop like a stone – but gave a boost to domestic import substitution, Veremis adds.

'This time it is much worse. The figures involved are huge, the debt is higher, the economy is more complex and unemployment has already risen to 25%, and double that for the young. Euro money went largely into building up a bloated, ineffectual state not into real investment and job creation. The priority now is to curb the public sector, which inevitably means a stiff price at the polls.'

Nikos Karamouzis, deputy CEO of Eurobank, adds that over-restrictive monetary policy, on top of the fiscal squeeze, has shrunk GDP by around 25%. 'This is a decline matched only by Latvia where 10% left to seek jobs abroad. Demoralised Greeks are leaving too, often the most skilled and best educated.' Policy, he complains, has concentrated on destroying demand, with no stimulus for private investment or guarantees of continuing Euro membership to provide hope of a long term solution. The main consequence is that public debt, which was 130% of GDP at the start of the crisis is forecast to rise to 192% of a now much smaller economy.

Economist George Pagoulatos says Greeks have lost a decade. Incomes are back to 2004 levels but prices, apart from rents which have fallen, are much stickier. 'We used to be European on the spending side but Greek on the tax revenue side. Incomes have fallen but military and other expenditure remains too high and we have not tackled the oligarchic structure which restricts competition and inhibits foreign investment. These structural problems should have been tackled much earlier in the crisis.'

Despite many months of often violent clashes between demonstrators and police the centre of Athens remains remarkably intact, with the exception of a burnt out bank where three employees were trapped and suffocated last summer, and the damaged marble steps of smart hotels on Syntagma square opposite parliament. Marble chips off nicely into missile-sized pieces to hurl at the police.

But gaunt, ragged men and women scavenge in litter bins in sight of the Parthenon and times are hard in the endless suburban sprawl down to Piraeus where Cosco, China's state shipping operator has leased a terminal to transfer on to smaller ships containers sent from Chinese ports through the Suez canal in big boats.

While the crisis is most acute in the big cities of Athens, Piraeus and Thessaloniki, smaller towns also have their share of protesters, as I found when the bus taking me from Sofia to Athens was forced into a detour round snow-capped Mount Olympus. Anti-austerity demonstrators had cut the main north-south highway near Larissa in the cotton growing centre of the country.

The consensus in Athens is that continuing Greek membership is safe while Germany views the fate of the southern states as a systemic risk.

Much depends on further debt relief and encouragement from the troika of the European commission, European Central Bank and International Monetary Fund. Many Greeks were dismayed when the latest austerity package voted through a reluctant parliament on 11 November merely sparked off a dispute between the European Commission and the IMF, instead of the expected reward of rapid disbursement of a €34bn loan. A deal was eventually agreed involving a further series of austerity measures, a slight relaxation of the path for fiscal stringency, and various elements of debt forgiveness and cancellation, including through large repurchases of Greek bonds from private sector holders. Part of the funds goes to recapitalising Greek banks, the rest will allow Antonis Samaras' fragile coalition to pay off suppliers and keep the show tenuously on the road.

There are few illusions left. 'Greeks now understand that the Euro was a fair weather system' says Veremis. But, he worries that politicians have still not spelt out clearly what a return to the drachma would mean. He believes that such a move would really push Greece towards another Katastrofi. 'Devaluation would lead to rapid inflation. This would deprive people of what remains of their savings and really get people out into the streets.' Both the neo-fascist Golden Dawn and the left-wing populist party Syriza would gain in strength.

Prime Minister Samaras is seen as the best last hope. Whatever his past mistakes, including an inflexibly hard line over what to call the former Yugoslav republic of Macedonia, and opposition to the first two austerity packages, he is now seen as a convinced supporter of continuing Greek membership of the euro, and the sole opportunity for a rational restructuring of the bureaucracy and the survival of parliamentary government.

The flaws of the 17-wheel euro chariot, designed without shock absorbers and no reverse gear, are now obvious. But what is also becoming clearer is that exit from the euro would mean exit from the EU. A return to the drachma would have to be accompanied by capital and other controls simply incompatible with continued membership of the single market, bankers and economists fear. The eastern Mediterranean is not a comfortable place to be alone in. Post-Second World War history before EU membership helped to consolidate democracy includes a savage civil war and rule by a military junta.

What is not clear are the longer term intentions of Germany, seen as the final arbiter of Greek destinies, and the willingness of reluctant voters in northern Europe to approve the kind of debt relief and transfers specifically ruled out by the euro founding fathers. The consensus in Athens is that continuing Greek membership is safe while Germany views the fate of the southern states as a systemic risk. The big question mark remains over what happens after next September's German elections.

Bulgaria profits from low costs and enhanced competitiveness

Bulgaria's outspoken prime minister Boyko Borisov ruffled Greek feathers recently when he suggested that Greek pensioners should learn to live with the same pensions as Bulgarians – around €100 a month. But his remarks reflect the wide income and performance gap which still remains between Greece and its northern neighbour whose national currency, the lev, was fixed to the D-Mark in a rigid currency board relationship in 1997, and then to the euro in 2002.

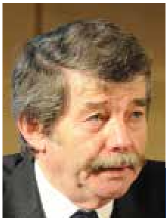
The currency board arrangement ensured that Bulgarians missed out on the great surge of debt-fuelled higher incomes enjoyed by Greece after 2002 and have left it, statistically, the poorest country in the entire EU. Not unconnected with this, Bulgaria also has among the best macro-statistics and sits alongside Finland and Denmark as one of the few EU countries to comply fully with all the Maastricht criteria.

According to Delyan Dobrev, the 34-year old head of Bulgaria's Economy, Energy and Tourism super-ministry, the budget deficit is expected at 1.5% of GDP this year and 1.7% in 2013, with the state debt/GDP ratio around 15%, compared with 130% and rising in Greece. While Greece is locked out of financial markets and dependent on further debt relief, Bulgaria's July €950m issue of five-year bonds with a 4.2% coupon was six times over-subscribed.

The combination of low wages and low taxes – both personal income and corporate taxes are a fixed 10% – and a pro-active foreign investment policy has attracted €900m this year alone, with increasing interest from Germany's private Mittelstand engineering companies as well as big-name companies such as Lufthansa, which bought the privatised assets of Balkan Air and converted its hangars at Sofia airport into a regional aircraft repair and maintenance hub.

And, while Bulgarians struggle on low incomes, and over 1m (in a nation of less than 8m) have emigrated in search of a better life, prices of food and services, as well as taxes, are much lower. Despite the EU-wide slowdown Bulgaria's GDP is also still growing. What is more, if the euro should break up, central bankers say, the lev would automatically revert to its former D-Mark peg. This will make the country even more attractive to German investors seeking to source more from lower-cost suppliers, especially relatively close and familiar ones like Bulgaria.

A regular round-up on international monetary affairs



Return of the sterling balances

Britain's hot money can flow out again

William Keegan, Chairman, Board of Contributing Editors

The recent build-up of overseas official holdings of sterling in London, highlighted by recent OMFIF research, evokes a few memories but also sounds some alarm bells.

My generation of economists, financial journalists, politicians and officials (especially Treasury and Bank of England officials) was almost obsessed by the issue of 'the sterling balances'.

One's bookshelves were lined with volumes bearing ominous titles such as The Problem of Sterling (A Conan) and Sterling in the Sixties (by none other than C W McMahon, usually known as 'Kit', who went on to have a distinguished career at the Bank of England, including experiencing, as Overseas Director of the Bank, the problem of Sterling in the Seventies).

Depending on one's point of view, and the vagaries of the financial markets, the sterling balances were variously considered a useful prop or a millstone round the British economy's neck. Thus they could offset the deleterious effect of a balance of payments deficit – indeed, finance it; or, in turbulent times, they could exert much greater downward pressure on the pound than might be warranted by the underlying domestic economic situation, intensifying speculative outflow.

That redoubtable financial commentator Nicholas Davenport, who wrote a brilliant column for The Spectator in its heyday under the proprietorship of Sir Ian Gilmour, would constantly issue warnings about the dangers of relying on what he termed 'hot money'. (Davenport also had it in for the officials who relied on these 'balances', whom he would refer to witheringly as 'the Treasury Knights'.)

However, those Knights, or their successors, were sufficiently concerned about the nation's vulnerability to sudden withdrawals as to work on various schemes to try to devise an orderly run-down of the sterling balances in the late 1960s and early 1970s.

Alas, the problem reasserted itself with a vengeance from 1973 onwards, with the onset of the first oil crisis. Officials who were worried about rising inflation and underlying balance of payments problems – Britain's year-on-year inflation rate peaked at 26.9% in August 1975! – could not make much headway with politicians while the money was flowing in. What happened was that some of the key oil exporters, in the Middle East and Nigeria, were traditional holders of sterling.

As their revenues ballooned in response to the quintupling of the posted oil price in 1974-75, we discovered that old habits die hard, and they parked their extra funds in London, thereby postponing the reckoning that hard-headed officials knew was coming.

Then, hey presto, early in 1976 the tide turned and the balances – Nicholas Davenport's 'hot money' – began to flow out. I myself had a fascinating experience, because early in 1976 I was reporting all this as Economics Correspondent for the Financial Times, and from April I was working at the Bank of England on secondment. For a poaching journalist turned temporary gamekeeper it was riveting. My new masters trusted me enough to give me access to the real state of the official reserve figures, which, yes, those conspiracy theories are sometimes well-founded, were being heavily 'cooked'.

When the outflow became a flood, the game was up, and the Labour government had to resort to borrowing from the International Monetary Fund – a searing episode, from which Labour took a long time to recover.

Now, as there is increasing concern about the trend of Britain's trade balance, one cannot help wondering about what will happen to all these new sterling balances when we experience the next collapse of confidence in sterling. Will the markets go too far? When will we find out the answer? Perhaps this will test the mettle of the new Bank of England governor.

Looking ahead – 2013 diary dates

Gold and the Renminbi – OMFIF Report launch
11 January, Renmin University, Beijing

China-Europe Economists Symposium
China-Europe Economy: Challenges and Opportunities
12 January, Shangri-La Hotel, Beijing

Lecture with James Bullard
President, Federal Reserve Bank of St. Louis
22 May, London

Lecture with Stanley Fischer
Governor, Central Bank of Israel
13 June, London